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The purpose of this letter is to inform you that the CalPERS Board of Administration has approved three asset allocation strategies which may be used by employers who contract to pre-fund their future OPEB costs through the California Employers' Retiree Benefit Trust (CERBT) program.

<u>OPEB Pre-funding Program</u>

Often retirees from public agencies receive Other Post Employment Benefits (OPEB), in addition to pension benefits, from the public agency from which they retire. The most common OPEB is medical insurance coverage. Dental insurance and life insurance are other examples of OPEB.

In compliance with governmental accounting standards, public employers measure and report their OPEB liabilities and annual required contribution (ARC). California public employers may contract to pre-fund their future OPEB costs through the CERBT program, administered by CalPERS. Participating employers may make contributions to the CERBT fund, a trust fund irrevocably dedicated to pre-funding employer OPEB liabilities.

Employer assets (contributions and investment return) held in the CERBT fund will be used to pay the future OPEB costs of the employer who contributed them to the trust. The CERBT is a self-funded program. Participating employers pay for all costs of administering the program.

The CalPERS Board of Administration sets CERBT investment policy and strategy and, through CalPERS Investment Office staff, manages CERBT investments. CERBT assets are invested in public market securities using an asset allocation strategy approved by the CalPERS Board.

<u>The CERBT Asset Allocation Strategy</u>

All CERBT fund assets are invested in asset classes comprised of public market securities. In March 2011, the CalPERS Board approved a change to the classes in which the assets of the CERBT fund are invested. Two new asset classes were added. These new asset classes are Inflation linked Bonds (TIPS), and Commodities (both classes will be held in the form of publicly traded indexes). These asset classes were added in order to provide improved portfolio diversification and lower volatility of expected returns that might be caused by inflation. The five asset classes approved by the CalPERS Board in March 2011 are shown in Exhibit 1.

Exhibit 1, Asset Classes

Asset Classes
Global Equity
U.S. Nominal Bonds
U.S. Inflation Linked Bonds
Global Public Real Estate
Commodities

The CERBT program invests an employer's assets into these five asset classes according to a specific asset allocation strategy. An asset allocation strategy is a planned investment designed to earn a long term expected rate of return at a given level of risk. "Long term" means time periods commensurate with the lifespan of the employer's OPEB plan (e.g., periods of 50 years or longer).

Note: The long term expected rate of return is not guaranteed to be achieved. The rate of return will vary from investment period to period. All CERBT investments include a risk that employers will earn negative rather than positive investment returns during any given investment time period.

In March 2011, the CalPERS Board of Administration authorized the CERBT program to offer three asset allocation strategies. The introduction of these strategies will be coordinated with the 6/30/2011 OPEB valuation reports that all participating CERBT employers will obtain and provide to the CERBT. The three asset allocation strategies are listed in Exhibit 2:

Exhibit 2, Asset Allocation Strategies

	Strategy 1	Strategy 2	Strategy 3
Discount Rate	7.61%	7.06%	6.39%[1]
Standard Deviation of Expected Returns	11.73%	9.46%	7.27%

[1] Corrected from 6.36%, 5/6/2011

All three asset allocation strategies invest to some extent in each of the five asset classes. The asset allocation strategies differ from one another in the extent to which they participate in each asset class. By changing the portion of assets allocated to each asset class in a systematic way, the long term expected rate of return and level of risk of each asset allocation strategy is made materially different from the other two strategies.

The public market securities that comprise the underlying asset classes do not change when the asset allocation strategy changes. For example, the composition of the

Global Equity asset class is the same for each asset allocation strategy. Rather, the strategies differ in the extent to which the Global Equities asset class is represented in a given strategy.

In December 2010, the Board directed staff to prepare an asset allocation strategy proposal that would not expose employers to increased volatility of long term expected investment returns. Strategy 1 is the proposal made by staff. Both the discount rate and volatility of Strategy 1 are slightly lower than those of the current CERBT asset allocation strategy.

Strategy 1, described in Exhibit 2 above, is the allocation strategy most similar to the CERBT asset allocation strategy now being used by the CERBT. In August 2011, the existing CERBT allocation strategy will be replaced by Strategy 1. In August 2011, CERBT fund assets of all participating employers will be redeployed into the Strategy 1 asset allocation. Thereafter, participating employers may remain in Strategy 1, or elect to use Strategy 2 or Strategy 3 when they present their biennial actuarial valuation report or Alternative Measurement Method (AMM), beginning with the 6/30/2011 report.

Asset Allocation Strategies 2 and 3 were developed in order to provide a wider selection of pre-funding alternatives to employers.

The Discount Rates of the Asset Allocation Strategies

When the CalPERS Board approved the establishment of the three asset allocation strategies, they also approved the discount rates associated with them. The discount rates are the long term assumed rates of investment return used to express the OPEB liabilities and future benefits in their “present value.” Present value is a mathematical way to describe the dollar value of future OPEB events in terms of dollar value today.

Participating CERBT employers will notice that the 7.75% discount rate of the current CERBT asset allocation strategy is not used in the new asset allocation strategies. Based on careful analysis of the current CERBT strategy, internal and external expert advisors to the CalPERS Board concluded that the current strategy was no longer likely to yield a long term assumed return of 7.75% and maintain the risk level expected of it. Investment market developments, attributable in part to the worldwide financial crisis of 2008-09, led these experts to recommend changes to the current asset allocation strategy.

The Impact of the Discount Rate on Measured OPEB Cost

The discount rate associated with the asset allocation strategy materially impacts the OPEB cost measurement of the actuarial valuation or AMM. Changing to a different asset allocation strategy can materially change the results of the actuarial valuation or AMM. Doing so is very likely to require the employer to obtain a new actuarial valuation or AMM report. Employers should refer to Governmental Accounting Standard Board Statement 45 (GASB 45) for guidance in this matter.
A lower discount rate will increase the present value of benefits and liabilities, and the annual required contribution (ARC) reported by the employer OPEB plan.

Discount Rate Development Methodology and Margin for Adverse Deviation

CalPERS actuaries followed Actuarial Standards of Practice (ASOP) to develop the discount rates recommended to the CalPERS Board. In the first step of the process, the actuaries and investment staff developed estimates of expected long term return and risk of various proposed asset allocation strategies. Strategy 1 was identified as the strategy most like the current CERBT asset allocation strategy. Strategies 2 and 3 were chosen in order to provide an appropriate range of return/risk choices to employers.

Next, following ASOP, CalPERS actuaries used these estimates of long term returns and risk to model ten thousand 50 year projections of possible long term returns. The discount rate chosen was at the median (50^{th} percentile) of the distribution of those thousands of 50 year projected returns. That is to say, half of the projections yielded a higher discount rate and half of them yielded a lower discount rate.

Actuaries sometimes make an additional adjustment to the discount rate. This adjustment is called the Margin for Adverse Deviation (MFAD). The MFAD is a downward adjustment of the discount rate. Often actuaries set discount rates at standard intervals (e.g., at 7.25%, or at 7.50%, or at 7.75%, etc.). In the case of Strategy 1, for example, some actuaries may prefer to round the discount rate downward to 7.50%. Both the nominal and the rounded discount rates are acceptable under ASOP.

The MFAD adds an additional level of conservatism to the actuarial model used to measure benefit costs. MFAD does NOT change the asset allocation strategy or the underlying asset classes. Rather, it changes the calculations of the actuarial valuation or the AMM. The MFAD, which lowers the discount rate, will increase the present value of benefits and liabilities, and the annual required contribution reported by the employer OPEB plan. The MFAD changes the likelihood of actuarial asset gains. During any specific year, the impact of the MFAD may increase or decrease actuarial asset gains or losses.

The Process of Selecting and Reporting the Asset Allocation Strategy

On 6/30/2011, and every two years thereafter, the governmental accounting standards require that all employers who participate in the CERBT must obtain an OPEB valuation report or an AMM cost report.

These reports rely on actuarial assumptions, one of which is the discount rate (described above). The discount rate is determined from the asset allocation strategy used to pre-fund the employer's OPEB costs.

When employers prepare their OPEB valuation reports, they may elect to prefund their OPEB costs using Strategy 1, 2, or 3. Only one strategy may be used. The strategies share the same asset classes. The strategies differ by their exposure to each asset class; each strategy is invested to some extent in all asset classes.

An employer will select an asset allocation strategy at the time the OPEB valuation report is prepared. The employer might base the choice on the characteristics of the employer OPEB plan or the employer's financial condition. For example, if a plan is very well funded, or if an employer expects to make significant withdrawals from the plan in the near term, then the employer may prefer strategies with lower return volatility. Lower return volatility is accompanied by lower expected return and, consequently, a lower discount rate.

Beginning on 6/30/2011, and every two years thereafter, employers will provide an OPEB actuarial valuation or AMM cost report to the CERBT so that CERBT can report compliant to GASB 43 on behalf of all participating employers. In addition to the OPEB cost report, the employer provides a "Summary of Actuarial Information" report and a "Certification of Funding Policy." Each document reports information consistent with the other two documents, indicating the discount rate and Asset Allocation Strategy on which they are based.

The "Summary of Actuarial Information" and the "Certification of Funding Policy" are provided by the CERBT program and may be downloaded from the CERBT webpage. These forms have been revised to incorporate information about the three asset allocation strategies. The forms that will be revised are identified in Exhibit 3. Participating employers must use these updated forms with the 6/30/2011 OPEB valuation report and thereafter.

Exhibit 3, Revised Documents

Form Name	**Release Date**
Summary of Actuarial Information	May 3, 2011
Certification of Funding Policy	May 3, 2011

Lead Time to Implement a New Asset Allocation Strategy Selection

If the employer chooses an allocation strategy different from the one used previously, then the CERBT program will redeploy the assets into the new strategy in the first month following the fiscal year quarter in which the new OPEB cost report (valuation or AMM) and the supporting documents are received and accepted by the CERBT program. For example, reports accepted in July – September will lead to asset redeployment in October; reports accepted in October – December will lead to asset redeployment in January; and so forth.

OPEB Actuarial Assumptions Model

Beginning with the 6/30/2011 OPEB valuation reports, employers will rely on a revised OPEB actuarial assumptions model that incorporates the discount rates of the three asset allocations strategies and other minor revisions. This revised OPEB actuarial assumptions model is available on the CERBT webpage.

Other Important Information

CERBT staff will discuss the policies and processes related to these new asset allocation strategies at all upcoming public workshops and meetings. You may register for those workshops by visiting the CERBT Fund Workshops page.

We strongly urge all participating CERBT employers to read the three agenda items from the March 2011 meetings of the CalPERS Board of Administration and committees, in which important matters regarding these asset allocations are discussed. These three agenda items are listed in Exhibit 4 below. The agenda items can be found on the Benefits of Investing with CalPERS page through the "Relevant CalPERS Board Agenda Items" link.

Exhibit 4, Relevant CalPERS Board Agenda Items

Date	**Committee**	**Agenda Item No.**
3/14/2011	Investment	4, plus two attachments
3/15/2011	Benefits & Program Administration	7b
3/15/2011	Benefits & Program Administration	7c, plus two attachments

CalPERS Board will take action to incorporate the newly approved asset allocation strategies into the CERBT investment policy during the summer of 2011. This policy revision will be proposed to the Board in June 2011. The Board will vote on the revised policy in August 2011. The investment policy will state the allocation target and range for each asset class used in each asset allocation strategy. Also, the investment policy will identify the performance benchmark of each strategy. Until the revised CERBT investment policy is approved, employers should rely on the information published in the March 2011 Board agenda items noted above.

For More Information

More information about the CERBT program can be obtained from the CERBT program webpages (http://www.calpers.ca.gov/cerbt/). Also, you may email to the CERBT program staff at core4u@calpers.ca.gov.

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CERBT Program